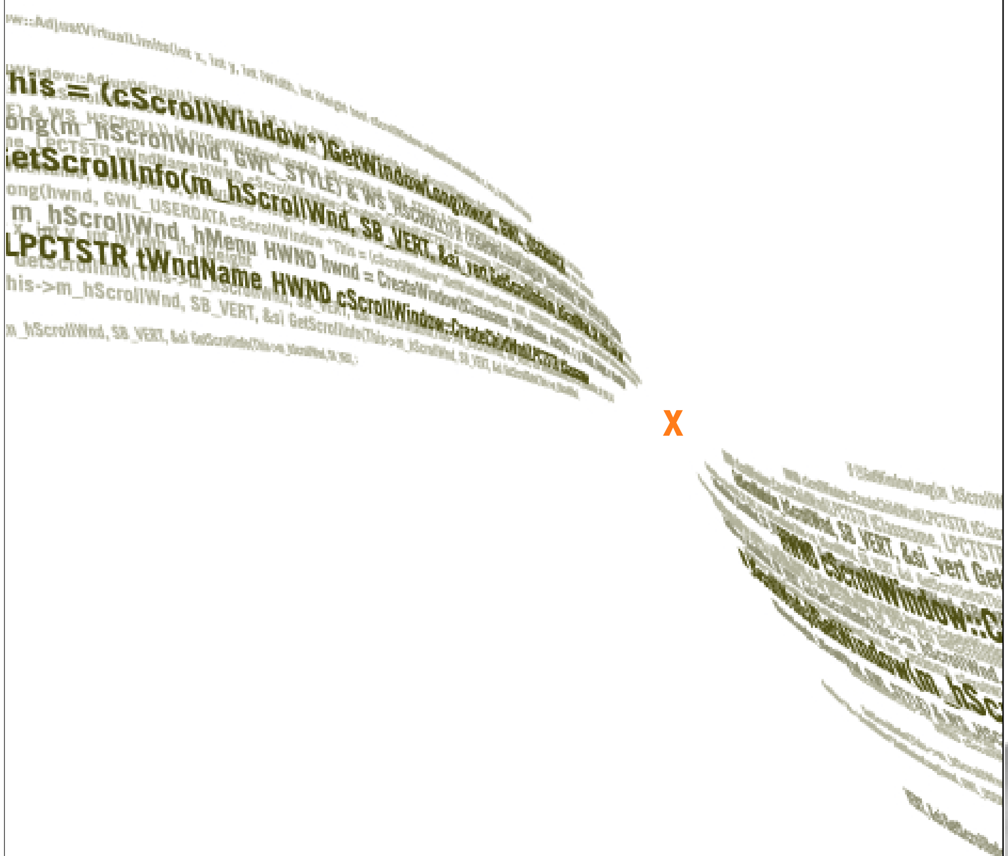
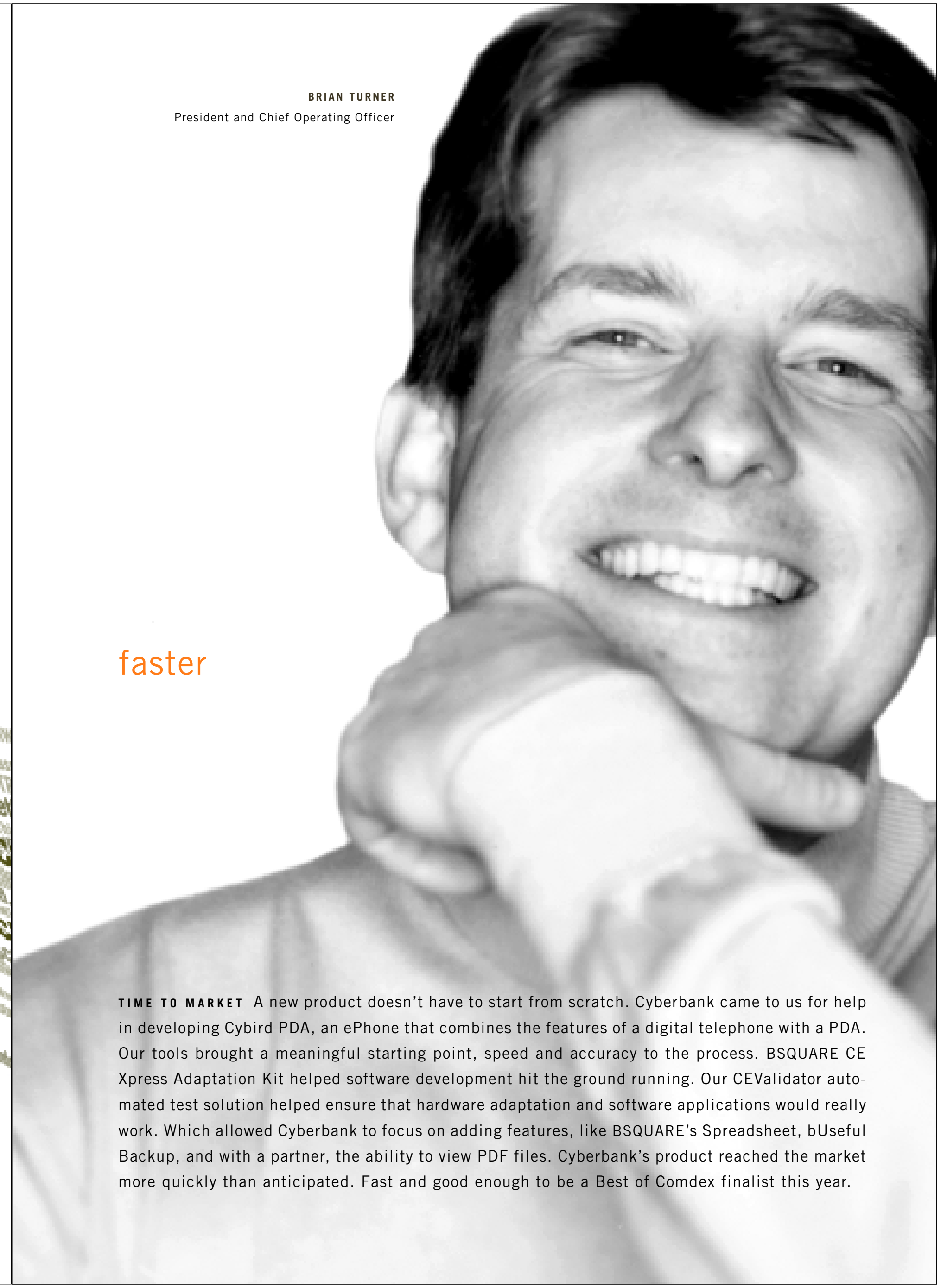
# BSQUARE : FRAMEWORK FOR X

## X is whatever you want it to be.

It can be faster time to market. New features and functionality. Better price and better performance. For companies that design and produce Intelligent Computing Devices, BSQUARE provides a framework of code and capability that helps them reach their goals, markets and customers. BSQUARE helps companies create the functions and capabilities that are changing the way we live, work, communicate and experience the world around us. For hardware design and software, X is whatever you can imagine. BSQUARE makes it possible.



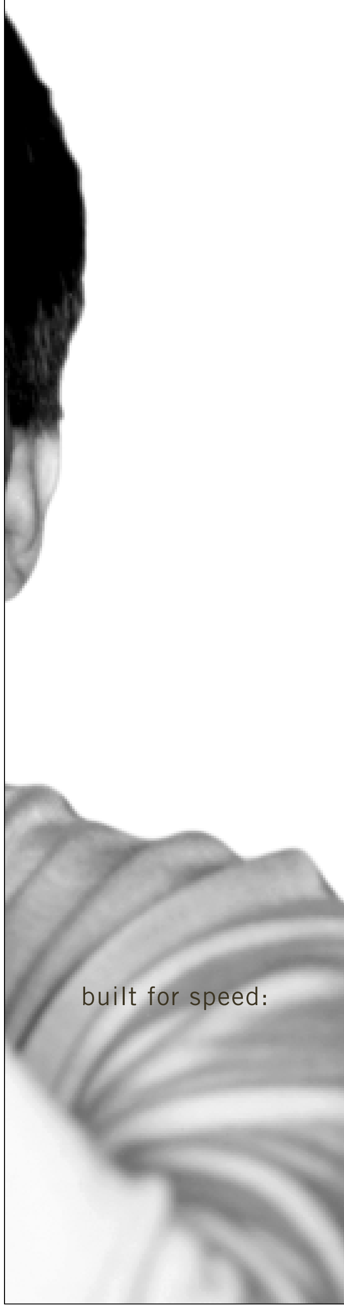
x



**BRIAN TURNER**
President and Chief Operating Officer

faster

**TIME TO MARKET** A new product doesn't have to start from scratch. Cyberbank came to us for help in developing Cybird PDA, an ePhone that combines the features of a digital telephone with a PDA. Our tools brought a meaningful starting point, speed and accuracy to the process. BSQUARE CE Xpress Adaptation Kit helped software development hit the ground running. Our CEValidator automated test solution helped ensure that hardware adaptation and software applications would really work. Which allowed Cyberbank to focus on adding features, like BSQUARE's Spreadsheet, bUseful Backup, and with a partner, the ability to view PDF files. Cyberbank's product reached the market more quickly than anticipated. Fast and good enough to be a Best of Comdex finalist this year.



**TOM SCHILD**

Senior Vice President,
Worldwide Sales and
International Operations

built for speed:

**CE Xpress Adaptation Kits**

Our processor-specific kits provide the software development and device driver tools necessary to adapt Microsoft Windows CE to a specific target device, shorten the product development cycle, and provide the fastest time to market.

**WinDK Device Driver Toolkit**

WinDK increases driver quality, and can save our customers months in the development of their device. Encapsulating thousands of lines of code, WinDK helps create device drivers for a variety of Microsoft platforms.


x

**LEILA KIRSKE**
Vice President,
Finance and Administration

complete

**COMPREHENSIVE SOLUTIONS** Our relationship with IBM continued to grow in 2000. IBM was looking for the right resource to help them extend their highly successful line of Thin Clients to include a new Windows-based terminal. Because they are managed from a central server, rather than a desktop PC, Thin Clients offer real value to users. BSQUARE supplied our Windows-based Terminal Solution along with our new Remote Device Administrator, essential in maximizing the performance of Thin Clients while keeping them in sync with the network, and tested with emulation software provided by our partner, FutureSoft. Finally, we created a customized training program for 150 IBM engineers, worldwide, to ensure an on-time, on-target global product launch.

**SCOTT BUFKIN**
Vice President, Professional Engineering Services

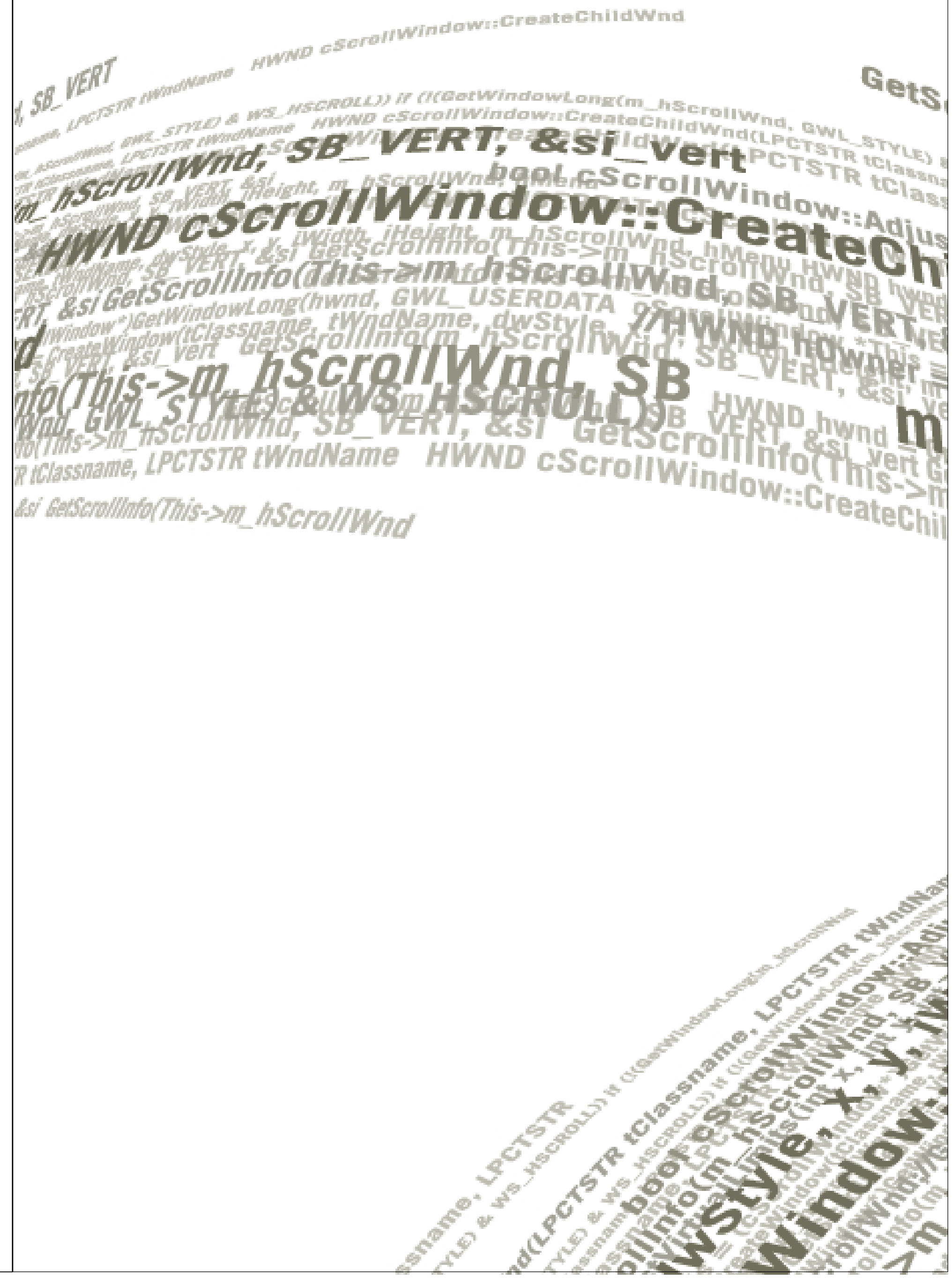
## thin client solutions:

**Remote Device Administrator**

Wireless updates to remote devices such as Thin Clients and Internet Appliances are enabled with Remote Device Administrator (RDA). Devices managed by RDA appear maintenance-free to end users, and the technology saves administrators both time and maintenance costs.

**Windows-based Terminals**

BSQUARE's proven technology and extensive experience in Microsoft Windows CE and NT Embedded are a valuable asset in the development of Thin Client devices. We provide the knowledge, tools and verification systems necessary to support this expanding market.



**DON WHITT**
Vice President and General Manager

new

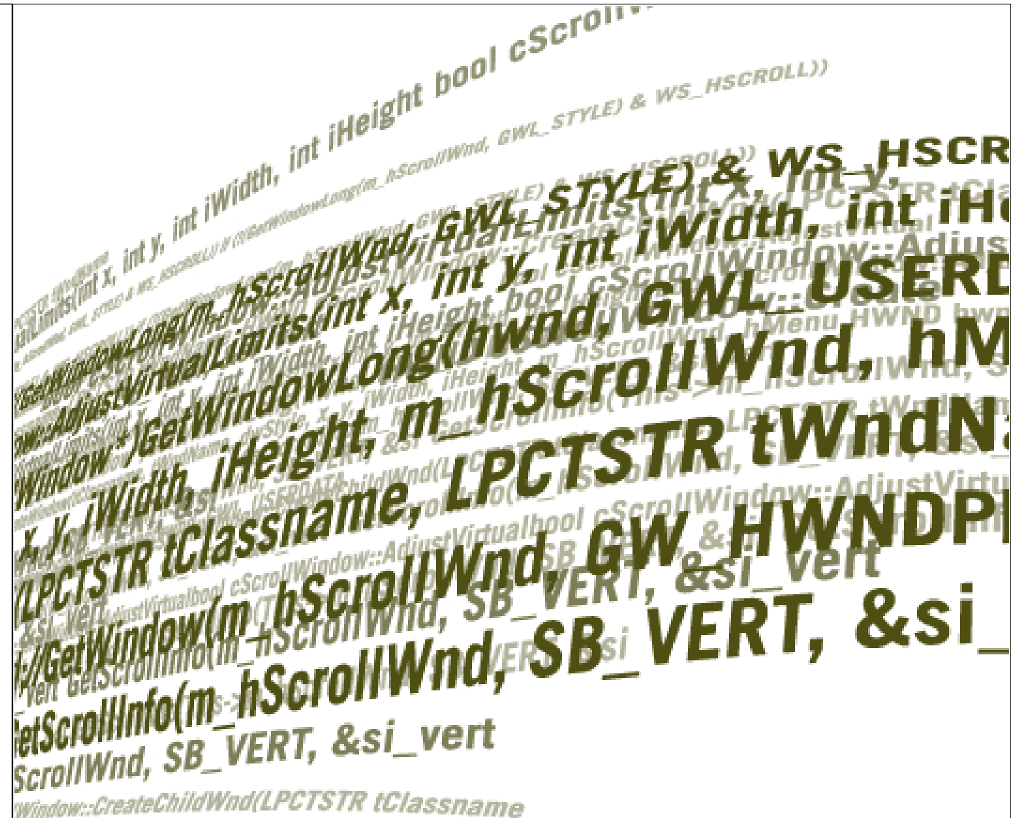
**INNOVATE** BSQUARE's suite of products and services, combined with the capabilities of our industry partners, provides customers with flexibility and access to the resources they need. For JVC's new Interlink handheld PC, BSQUARE matched our quality assurance technology to JVC's specific manufacturing needs, providing them with unmatched quality assurance testing throughout every phase of manufacturing. Add our end-user software applications, like bFax and bUseful Backup, and BSQUARE provided JVC with a comprehensive package of services, skills and products that helped their new product deliver on time, add value for their customers, and get on to the next breakthrough, even faster.

**LEW LARSON**
Vice President, Marketing

## testing innovation:

**CEValidator PassPORT, PassCODE, PassPOINT**

Our CEValidator testing suites save our customers both time and expense by automating the quality assurance processes for testing new products and applications. With PassPORT, PassCODE and PassPOINT, OEMs run test plans and scripts quickly and efficiently, freeing time to develop their products to their highest potential, rather than focusing on time-consuming tests and test automation development.



OLL)) > webpads

eight > Internet appliances

ATA > auto PCs

enu > windows terminals

ame > industrial handhelds

REV) > digital set-top boxes

_vert > consumer handhelds

talented

**CHRISTI LIEBE**
Vice President,
Information Technology

**GROWTH** From Munich to Silicon Valley. From Minneapolis to Tokyo to our home office in Bellevue, Washington, more than 500 dedicated, talented and driven individuals focus on the right answers for our growing list of customers. Together, our people offer expertise in multiple operating systems and software development tools. They help problem-solve the emerging technological issues that impact and ultimately transform the way we work, communicate and live. In 2000, 54 million Intelligent Computing Devices came to market worldwide. This number is expected to grow to 139 million devices worldwide in 2001. Working with BSQUARE ensures that those new products offer the features and value to succeed in an increasingly competitive marketplace.

## to our shareholders

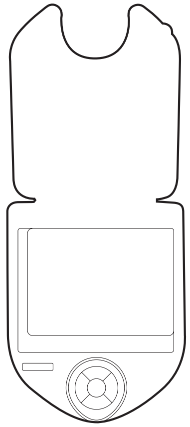
**BILL BAXTER**
Founder, Chairman and Chief Executive Officer

The past year was full of accomplishments. I hope you're already aware of the outstanding performance BSQUARE achieved in 2000. We are committed to innovation and delivering solutions to our customers. We believe that these results are the best evidence of that commitment. In 2000, BSQUARE recorded $63.5 million in revenue, and achieved 23 cents per share for cash-based earnings, exceeding analysts' forecasts. By the fourth quarter of 2000, 12% of our revenue was generated by the sale and license of products.

We outperformed in design wins, too. BSQUARE achieved 563 compelling design wins, up from 155 design wins in 1999. Accordingly, BSQUARE's customer base grew from 59 new customers in 1999 to 385 new customers in 2000 including design wins for 178 repeat customers. We signed three major semiconductor contracts with Matsushita, Mitsubishi and Infineon. To stay close to our customers, BSQUARE now has three domestic locations and two international locations with strategic partnerships all over the world.

Since BSQUARE went public in October of 1999, our markets have continued to evolve, providing us with broader opportunities. While maintaining our focus on our core businesses, we have placed a strategic emphasis on diversifying in order to leverage these new business opportunities. Being prepared for change in an industry that develops as rapidly as ours is key. When





**Development : Cybird PDA**

Cyberbank licensed BSQUARE's CE Xpress Adaptation Kits to ensure speed and accuracy in developing software for their next-generation Cybird PDA. We also provided Cyberbank with our CE Validator automated test solutions to make certain that all the features and functions really worked.

**Execution : Cybird PDA**

Cyberbank's product reached the market in record time, fast enough and good enough to be a finalist for the Best of Comdex award this year. Cybird features BSQUARE's Spreadsheet, bUseful Backup, and a third party's PDF-viewing software.

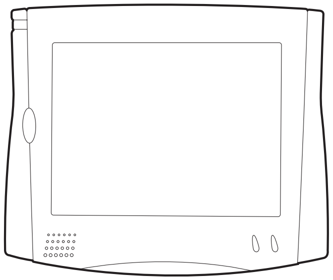
BSQUARE began building a business to facilitate the adoption of Intelligent Computing Devices (ICDs), the industry was in its infancy. So we created low-level tools to help semiconductor manufacturers integrate their microprocessors with operating systems. Once there was a sufficient diversity of microprocessors, the emphasis shifted to the Original Equipment Manufacturers. BSQUARE assisted them in developing their devices. Today, we are entering a new phase in the evolution of ICDs. Since there is now a growing supply of powerful devices, our focus must extend to deployment and management of the devices.

Throughout our history, we have mirrored the evolution of this industry. In 2000 we released new products that focus on enabling Enterprises and Service Providers to deploy and manage ICDs. Our Remote Device Administrator™ (RDA) is an example of that product evolution.

With RDA, people seeking to deploy heterogeneous networks of ICDs can do so feeling confident in their ability to manage those assets in a way that delivers on their true promise: ease of use and ease of maintenance.

RDA became a reality because our view is a comprehensive one. Throughout the past year, BSQUARE's goal has been to create a complete framework for both developing and deploying ICDs. This framework consists of four components: first, powerful software that enables the remote management of devices – our Remote Device Administrator; second, software that enables the rapid prototyping and deployment of devices – iWin™; third, software that enables the device to connect with the network – Communications Infrastructure, including our Flagship BlueTooth Extensions for WinDK®; and finally, software that helps improve programmer productivity, making it faster and easier to get





**Development :** Wireless Web Pad

BSQUARE provides complete platform solutions for the development of wireless web pads and other Internet appliances. Our customers are able to quickly and easily integrate wireless connectivity with our WinDK Extension for Bluetooth, which reduces development cost and gets their Internet appliance to market fast.

**Execution : Wireless Web Pad**

Developers have complete control over the look, feel and functionality of their final product with our iWin Information Appliance Design Kit. From design to testing, deployment to management, BSQUARE's products expedite and enhance the development of Internet appliances.

products to market – development and deployment tools including our Flagship WinDK and CE Validator.™

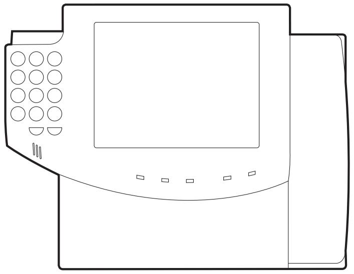
Combining these essential components enables our customers to achieve a complete solution from a single supplier. When added to our world-class engineering services, we can get our customers to market with innovative, robust solutions in the least amount of time. That is the promise BSQUARE offers to our customers. That is the promise we deliver on.

We have enhanced the opportunity for the broad adoption of these solutions by establishing strategic partnerships with industry leading companies. From semiconductor companies such as Infineon, Matsushita and Mitsubishi to OEMs such as Philips and Panasonic, BSQUARE has established partnerships that directly and indirectly enable the proliferation of our framework.

As BSQUARE continues to solidify its position with our comprehensive ICD development and management framework, we will leverage new revenue opportunities. Our revenue streams once included engineering services, up-front license fees, and per-device royalties. In 2000, we were able to add a fourth revenue stream: Client Access Licenses (CAL).

Research indicates that, in the markets we focus on there will be 250 to 500 million new devices shipped in 2004 alone. This is up from about 30 million units in 1999. With 563 new design wins in 2000, the product royalty revenue opportunity for BSQUARE should begin to materialize in 2001 and 2002. Looking further ahead, we feel BSQUARE is exceptionally well positioned to capitalize on the opportunity created by these new devices as they reach the consumer. The customers we licensed software to in 2000 should see their products come to market as





**Development : IPM Smilephone**

BSQUARE contributed software, hardware design and program support in the development of IPM's Smilephone, a screenphone that serves as a web browser, e-mail manager and phone. We supplied the drivers and OAL layers, and worked with Microsoft on the Web Telephone Edition of Windows CE.

**Execution : IPM Smilephone**

BSQUARE's strategic involvement with the Smilephone didn't stop at software development, but extended into the execution of the hardware. Our recommendations for modifications to the device enhanced IPM's final product.

Smilephone product and design are property of IPM-NET

early as 2001. We should also begin to see income from new Client Access Licenses based on devices managed by BSQUARE RDA in the near future. The potential of these four revenue streams indicates that BSQUARE should see continued revenue growth in 2001.

Of course, we believe that BSQUARE will continue to add more new royalty-bearing customers. We'll also refine RDA and iWin to meet growing needs across the markets we address. We'll also produce more market-specific solutions for consumer and enterprise products. And we will continue to focus on controlling expenses, improving our marketing and sales efforts, as well as fine-tuning our product mix. Most importantly, BSQUARE will remain focused on business fundamentals as we continue to strive to further improve revenue, earnings and shareholder equity. We will do this by leveraging the ability and skill of more than

500 outstanding employees and a great management team: the people of this corporation are our single greatest asset and we will continue to invest in the development of that asset. Together, they are our competitive edge.

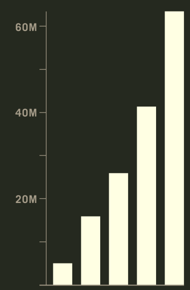
There are enormous opportunities before us: a rapidly growing market, broadening sources of revenue and powerful alliances all combined with the fact that BSQUARE offers a combination of resources and products that no one competitor can match. Thank you for your interest in BSQUARE Corporation. It is a company we deeply believe in and are working hard to continuously improve.

William T. Baxter

**WILLIAM T. BAXTER**
Founder, Chairman and Chief Executive Officer

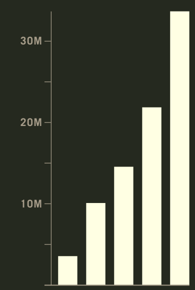


# financial review



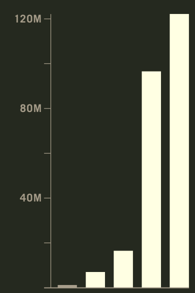

**Revenue**
dollars in thousands

2000: 63,502
1999: 41,406
1998: 25,937
1997: 15,914
1996: 5,026



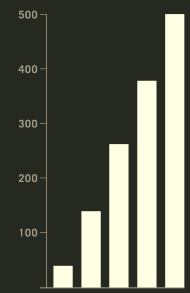

**Gross Profit**
dollars in thousands

2000: 33,716
1999: 21,897
1998: 14,574
1997: 10,099
1996: 3,546




**Total Assets**
dollars in thousands

2000: 122,262
1999: 96,642
1998: 16,448
1997: 6,921
1996: 1,155




**Number of Employees**

2000: 501
1999: 379
1998: 263
1997: 140
1996: 40

# Selected Financial Data

in thousands, except per share amounts

| Year Ended December 31, | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|
| **Consolidated Income Statement Data:** | | | | | |
| Revenue | $ 5,026 | $ 15,914 | $ 25,937 | $ 41,406 | $ 63,502 |
| Cost of revenue | 1,480 | 5,815 | 11,363 | 19,509 | 29,786 |
| Gross profit | 3,546 | 10,099 | 14,574 | 21,897 | 33,716 |
| Operating expenses: | | | | | |
| Research and development | 771 | 2,086 | 4,438 | 7,506 | 9,259 |
| Selling, general and administrative | 773 | 3,117 | 6,825 | 11,935 | 16,675 |
| Acquired in-process research and development | – | – | – | – | 4,100 |
| Amortization of intangible assets | – | – | – | – | 2,920 |
| Amortization of deferred stock option compensation | – | 81 | 171 | 583 | 554 |
| Total operating expenses | 1,544 | 5,284 | 11,434 | 20,024 | 33,508 |
| Income from operations | 2,002 | 4,815 | 3,140 | 1,873 | 208 |
| Investment income (expense), net | 3 | (8) | 326 | 926 | 3,282 |
| Acquisition related expense | – | – | – | – | (620) |
| Income before income taxes | 2,005 | 4,807 | 3,466 | 2,799 | 2,870 |
| Provision for income taxes | – | 804 | 1,166 | 1,104 | 2,136 |
| Net income | $ 2,005 | $ 4,003 | $ 2,300 | $ 1,695 | $ 734 |
| Basic earnings per share | $ 0.09 | $ 0.18 | $ 0.12 | $ 0.08 | $ 0.02 |
| Weighted average shares used to compute basic earnings per share | 22,367 | 21,661 | 18,633 | 21,430 | 33,275 |
| Diluted earnings per share | $ 0.09 | $ 0.18 | $ 0.08 | $ 0.06 | $ 0.02 |
| Weighted average shares used in computation of diluted earnings per share | 22,367 | 22,042 | 27,736 | 30,800 | 35,932 |

| December 31, | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|
| **Consolidated Balance Sheet Data:** | | | | | |
| Cash, cash equivalents and short-term investments | $ 223 | $ 2,528 | $ 7,056 | $ 82,972 | $ 72,351 |
| Working capital | 775 | 3,161 | 10,527 | 81,675 | 76,560 |
| Total assets | 1,155 | 6,921 | 16,448 | 96,642 | 122,262 |
| Long-term obligations, net of current portion | – | 1,743 | 289 | – | 353 |
| Mandatorily redeemable convertible preferred stock | – | – | 14,417 | – | – |
| Shareholders' equity (deficit) | 1,060 | 2,663 | (965) | 89,125 | 108,347 |

# Management's Discussion and Analysis of Results of Operations and Financial Condition

## → Forward-looking Statements

This Annual Report and the documents incorporated herein by reference contain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 based on current expectations, estimates and projections about our industry and our management's beliefs and assumptions. When used in this Annual Report and elsewhere, the words "believes," "plans," "estimates," "intends," "anticipates," "seeks" and "expects" and similar expressions are intended to identify forward-looking statements. These forward-looking statements include, but are not limited to, statements about our plans, objectives, expectations and intentions and other statements that are not historical facts. These forward-looking statements are not guarantees of future performance and are subject to certain risks and uncertainties that are difficult to predict. Accordingly, actual results may differ materially from those anticipated or expressed in such statements. Particular attention should be paid to the cautionary statements contained in this Annual Report under "Risk Factors" involving potential fluctuations in our quarterly operating results, our reliance on Microsoft, uncertainty about the Windows CE market, unpredictability of future revenue, the intensely competitive nature of our industry, our ability to protect our intellectual property rights, management of growth, the integration of any future acquisitions and our reliance on third parties, manufacturers, distributors and suppliers. Readers are cautioned not to place undue reliance on the forward-looking statements, which speak only as of the date made. Except as required by law, we undertake no obligation to update any forward-looking statement, whether as a result of new information, future events or otherwise. Readers, however, should carefully review the factors set forth in this and other reports or documents that we file from time to time with the Securities and Exchange Commission.

The following Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with our consolidated financial statements and related notes.

## → Overview

We are a leading provider of software solutions that enable the creation and deployment of a wide variety of intelligent computing devices based on the Microsoft Windows-based operating systems. We work with semiconductor vendors and original equipment manufacturers to provide software products and engineering services for the development of intelligent computing devices.

We enable the rapid and low-cost deployment of intelligent computing devices by providing a variety of software products and services for the development, integration and deployment of Windows-based operating systems with industry-specific applications. We also develop software applications that are licensed to OEMs to provide intelligent computing devices with additional functionality. Our products and services are marketed and supported on a worldwide basis through a direct sales force augmented by distributors.



Our revenue totaled $25.9 million in 1998, $41.4 million in 1999 and $63.5 million in 2000. We generated net income of $2.3 million in 1998, $1.7 million in 1999 and $734,000 in 2000.

To date, we have derived the majority of our revenue from the provision of services to Microsoft, semiconductor vendors and original equipment manufacturers. We also generate product revenue from software sales and royalty licenses. We perform our services under both time-and-materials contracts and fixed-fee contracts. We also receive a small portion of service revenue from the provision of contract support services upon the purchase of our software products. We sell our packaged software products through our direct sales force and through indirect channels, such as resellers. In addition, we receive royalty payments from original equipment manufacturers related to the bundling of our software on their intelligent computing devices and, more recently, from the license to them of software products contained in our intelligent computing device integration tool kits.

On January 5, 2000, we acquired BlueWater Systems, Inc., a privately held designer of software development tools for the creation of Windows-based intelligent computing devices. The transaction was accounted for using the pooling-of-interests method of accounting. All of our financial data presented in the consolidated financial statements and results of operations have been restated to include the historical financial information of BlueWater Systems, Inc. as if it had always been a part of BSQUARE.

On May 24, 2000, we acquired Mainbrace Corporation in a transaction accounted for as a purchase. Mainbrace Corporation, located in Sunnyvale, California, is an intellectual property-licensing and enabling software firm delivering products and services to high-volume market segments including set-top boxes, web-enabled phones, wireless thin clients and electronic book readers. The financial data presented in the consolidated financial statements include the results of operations of Mainbrace Corporation beginning on May 25, 2000.

## → Microsoft Master Development and License Agreement

For the years ended December 31, 1998, 1999 and 2000, approximately 75%, 85% and 58% of our revenue, respectively, was generated under our master development and license agreement with Microsoft. The master agreement, the current term of which concludes in July 2001, includes a number of project-specific work plans. We bill Microsoft on a time-and-materials basis, although each project has a maximum dollar cap, and recognize revenue generated under the master agreement as the services are rendered. The master agreement and each of the individual work plans may be modified or terminated by Microsoft at any time. While we anticipate that our relationship with Microsoft will remain strong, we are unable to predict the magnitude and number of future projects for Microsoft.

## Historical Results of Operations

The following table presents certain financial data as a percentage of total revenue for the periods indicated. Our historical operating results are not necessarily indicative of the results for any future period.

### Consolidated Statement of Operations Data

| As a Percentage of Total Revenue<br>Year Ended December 31, | 1998 | 1999 | 2000 |
|---|---|---|---|
| Revenue: | | | |
| Service | 91% | 94% | 90% |
| Product | 9 | 6 | 10 |
| Total revenue | 100 | 100 | 100 |
| Cost of revenue: | | | |
| Service | 43 | 46 | 44 |
| Product | 1 | 1 | 3 |
| Total cost of revenue | 44 | 47 | 47 |
| Gross margin | 56 | 53 | 53 |
| Operating expenses: | | | |
| Research and development | 17 | 18 | 15 |
| Selling, general and administrative | 26 | 29 | 26 |
| Acquired in-process research and development[1] | – | – | 6 |
| Amortization of intangible assets[2] | – | – | 5 |
| Amortization of deferred stock option compensation | 1 | 1 | 1 |
| Total operating expenses | 44 | 48 | 53 |
| Income from operations | 12 | 5 | – |
| Investment income, net | 1 | 2 | 5 |
| Acquisition related expense[2] | – | – | (1) |
| Income before income taxes | 13 | 7 | 4 |
| Provision for income taxes | 4 | 3 | 3 |
| Net income | 9% | 4% | 1% |

1 The consolidated statements of operations for the year ended December 31, 2000 includes a $4.1 million (6% of total revenue) charge for acquired in-process research and development costs associated with our purchase of Mainbrace Corporation in May 2000.

2 The consolidated statements of operations for the year ended December 31, 2000 include charges of $2.9 million (5% of total revenue) in amortization of intangible assets, as well as $620,000 (1% of revenue), of acquisition related expenses associated with a pooling of interests transaction occurring during 2000.



## Comparison of the Years Ended December 31, 1998, 1999 and 2000

### Revenue

Revenue consists of service and product revenue, which includes software license fees and royalties. Total revenue increased 60% from $25.9 million in 1998 to $41.4 million in 1999, and an additional 53% to $63.5 million in 2000. Microsoft accounted for 75%, 85% and 58% of total revenue in 1998, 1999 and 2000, respectively. The decrease in the percentage of revenue derived from Microsoft in 2000 over 1999 is due to the signing of silicon vendors under the Porting Partner Agreement and the growth in services provided to OEM customers. We expect that in future periods, the percentage of revenue derived from Microsoft will continue to decline.

Revenue outside of North America totaled $1.2 million in 1998, $1.5 million in 1999 and $13.5 million in 2000. The increase in international revenue from 1998 to 1999 is the result of an increase in the number and size of software integration service and product contracts with OEMs in Asia Pacific and Europe. The increase in international revenue from 1999 to 2000 is due to an increase in both services and products sold to international porting partners and OEM customers located in Asia Pacific. We expect international sales will continue to represent a significant portion of revenue, although its percentage of total revenue may fluctuate from period to period.

**SERVICE REVENUE** Service revenue increased 64% from $23.7 million in 1998 to $38.8 million in 1999, and an additional 47% to $57.2 million in 2000. The increase in service revenue for all periods was due to the increasing number and size of software consulting projects. As a percentage of total revenue, service revenue increased between 1998 and 1999 due to an increase in the growth of the number and size of software integration contracts. As a percentage of total revenue, service revenue decreased between 1999 and 2000 due to product sales increasing at a faster rate than service revenue.

**PRODUCT REVENUE** Product revenue increased 15% from $2.2 million in 1998 to $2.6 million in 1999 and an additional 144% to $6.3 million in 2000. The increase in product revenue for all periods is due to the expansion of product offerings and increased sales of intelligent computing device integration tool kits and CE Validator quality assurance test suites as well as royalties received from OEMs from the license of our software. As a percentage of total revenue, product revenue decreased from 9% in 1998 to 6% in 1999 due to the service revenue growth rate increasing at a faster rate than products, resulting from increases in the number and size of software integration contracts. As a percentage of total revenue, product revenue increased to 10% in 2000 from 6% in 1999 due to expanded product offerings and sales.

### Cost of Revenue

**COST OF SERVICE REVENUE** Cost of service revenue consists primarily of salaries and benefits for software developers and quality assurance personnel, plus an allocation of facilities and depreciation costs. Cost of service revenue increased 72% from $11.0 million in 1998 to $19.0 million in 1999 and an additional 49% to $28.2 million in 2000. These increases resulted from the hiring and training of additional employees to support our growing customer base. At December 31, 1998, 1999 and 2000, we had 160, 231 and 311 employees, respectively, engaged in software engineering consulting. Cost of service revenue as a percentage of related service revenue was 47% in 1998, 49% in 1999 and 49% in 2000. The increases in cost of service revenue as a percentage of related service revenue reflect higher personnel costs related to the competitive employee recruiting and retention pressures in the greater-Seattle and Silicon Valley areas, as well as higher facilities and depreciation costs associated with expansion into multiple locations in the United States through our acquisitions. Although cost of service revenue as a percentage of the related service revenue remained relatively constant for 2000 over 1999, cost of service revenue may increase in future periods due to continued competition in employee recruiting and retention pressures, and as we expand our facilities in Silicon Valley and Eden Prairie, Minnesota.

**COST OF PRODUCT REVENUE** Cost of product revenue consists of license fees and royalties for third-party software, product media, product duplication and manuals. Cost of product revenue increased 62% from $326,000 in 1998 to $529,000 in 1999, and an additional 201% to $1.6 million in 2000. Cost of product revenue as a percentage of related product revenue was 15% in 1998, 20% in 1999 and 25% in 2000. The increase in cost of product revenue as a percentage of related product revenue from 1998 to 1999 relates to a change in mix of product sales from royalties received from original equipment manufacturers for licenses of applications in 1998 to a higher proportion of pre-packaged BSQUARE and third-party applications in 1999. The increase in cost of product revenue as a percentage of related product revenue from 1999 to 2000 relates to an increase in sales of third-party products in 2000 over the same period in 1999.

### Operating Expenses

**RESEARCH AND DEVELOPMENT** Research and development expenses consist primarily of salaries and benefits for software developers, quality assurance personnel, program managers and an allocation of our facilities and depreciation costs. Research and development expenses increased 69% from $4.4 million in 1998 to $7.5 million in 1999, and an additional 23% to $9.3 million in 2000. These increases relate primarily to the increase in the number of software developers and quality assurance personnel hired to expand our product offerings and to support our product development and testing activities. Research and development expenses represented 17% of our total revenue in 1998, 18% in 1999 and 15% in 2000. The increase in research and development expense as a percentage of total revenue between 1998 and 1999 primarily reflects the more rapid investment in our research and development activities compared to the growth of our revenue during this period. The decrease in research and development expense as a percentage of total revenue between 1999 and 2000 primarily reflects the strong growth of our product revenue compared to the investment in research and development during this period. We anticipate that research and development expenses will continue to increase in absolute dollars in future periods.

**SELLING, GENERAL AND ADMINISTRATIVE** Selling, general and administrative expenses increased 75% from $6.8 million in 1998 to $11.9 million in 1999, and an additional 40% to $16.7 million in 2000. These increases resulted primarily from our investment in finance, executive, administration, sales and marketing infrastructure, both domestically and internationally, which included significant personnel-related expenses, travel expenses and related facility and equipment costs, as well as increased marketing activities, including trade shows, public relations and other promotional expenses. Selling, general and administrative expenses represented 26% of our total revenue in 1998, 29% in 1999 and 26% in 2000. The increase in selling, general and administrative expenses as a percentage of total revenue between 1998 and 1999 primarily reflects the more rapid investment in our administrative and sales and marketing infrastructure compared to the growth of our revenue during this period. The decrease in selling, general and administrative expenses as a percentage of total revenue between 1999 and 2000 primarily reflects the larger percentage increase in revenue compared to the growth of selling, general and administrative expenses. During the fourth quarter of 1998, we opened sales offices in Munich, Germany and Tokyo, Japan. To establish and operate these offices, we invested $502,000 in 1998, $1.9 million in 1999, and $2.4 million in 2000, which are included in the expense amounts above. We anticipate that selling, general and administrative expenses will continue to increase in absolute dollars in future periods as we expand our sales and marketing staff both internationally and domestically.

**ACQUISITION OF IN-PROCESS RESEARCH AND DEVELOPMENT AND AMORTIZATION OF INTANGIBLE ASSETS** On May 24, 2000, we acquired Mainbrace Corporation, an IP-licensing and enabling software firm delivering product solutions to high volume market segments including set-top boxes, Web-enabled phones, wireless thin clients, and electronic book readers. The acquisition was accounted for using the purchase method of accounting and, accordingly, the results of Mainbrace's operations are included in our consolidated financial statements since the date of acquisition.

The purchase price was allocated to the fair value of the acquired assets and assumed liabilities based on their fair market values at the date of the acquisition. Of the total purchase price, we allocated $4.1 million to acquired in-process research and development, $19.7 million to goodwill and other intangible assets and $1.0 million to working capital and tangible assets. The amount allocated to in-process research and development was determined by an independent valuation and has been recorded as a charge to expense because its technological feasibility had not been established and it had no alternative future use at the date of acquisition. Goodwill and other intangible assets are amortized over their estimated future lives, two to seven years.

Additionally during 2000, we acquired two smaller companies, Embedded Technologies Inc. and ToolCraft KK, for total cash and stock consideration of approximately $5.0 million. These acquisitions were accounted for using the purchase method of accounting. The purchase prices were allocated to the fair value of the acquired assets. In connection with these acquisitions, we recorded $4.1 million of goodwill and other intangible assets, which is amortized over their useful lives, two to seven years.

We anticipate that future amortization of intangible assets will approximate $6.0 million per year.

**AMORTIZATION OF DEFERRED STOCK OPTION COMPENSATION** We recorded amortization of deferred stock option compensation of $171,000 in 1998, $583,000 in 1999 and $554,000 in 2000. These charges resulted from stock option grants at prices below the deemed fair market value of our common stock when we were a private company. Deferred stock option compensation is amortized over the vesting periods of the options.

### Other Income (Expense), Net

Investment income, net was $326,000 in 1998, $926,000 in 1999 and $3.3 million in 2000. These increases resulted from higher average cash, cash equivalent and short-term investment balances over the prior year.

In January 2000, the Company acquired BlueWater Systems, Inc. in a transaction accounted for as a pooling of interests. In connection with the acquisition, we incurred $620,000 of acquisition-related costs, which were charged to operations during the year ended December 31, 2000.

### Provision for Income Taxes

Our provision for federal, state and international income taxes was $1.2 million for 1998, $1.1 million for 1999 and $2.1 million for 2000, yielding an effective rate of 33.6%, 39.4% and 74.4% in 1998, 1999 and 2000, respectively. The increase in the effective tax rate in 1999 over 1998 was due primarily to the effect of the non-deductibility of losses from our international operations. The effective rate in 2000 was positively affected by the tax benefit of interest income earned on tax-advantaged municipal securities held in our short-term investment portfolio, and was negatively affected by the non-deductibility of in-process research and development and amortization of intangible assets.

### Pro Forma Cash Basis Net Income

Pro forma cash basis net income, which excludes deferred stock option compensation, acquired in-process research and development, amortization of intangible assets, and acquisition-related costs, is as follows:

| In Thousands<br>Year Ended December 31, | 1998 | 1999 | 2000 |
|---|---|---|---|
| Net income | $ 2,300 | $ 1,695 | $ 734 |
| Acquired in-process research and development | – | – | 4,100 |
| Amortization of intangible assets, net of tax effect | – | – | 2,628 |
| Amortization of deferred stock option compensation, net of tax effect | 111 | 379 | 361 |
| Acquisition related expense, net of tax effect | – | – | 515 |
| Cash basis net income | $ 2,411 | $ 2,074 | $ 8,338 |
| Diluted earnings per share | $ 0.08 | $ 0.07 | $ 0.23 |
| Weighted average shares outstanding to compute diluted earnings per share | 27,736 | 30,800 | 35,932 |

The pro forma results are presented for informational purposes only and are not prepared in accordance with generally accepted accounting principles.



### → Liquidity and Capital Resources

Since our inception, we financed our operations and capital expenditures primarily through cash flow from operations. As of December 31, 2000, we had $72.4 million of cash, cash equivalents and short-term investments. In October 1999, we completed an initial public offering of 4,000,000 shares of common stock and raised $54.4 million, net of offering costs. In addition, in September 1999, we sold 1,518,378 shares of our common stock to Vulcan Ventures for approximately $18.7 million. In January 1998, we issued mandatorily redeemable convertible preferred stock from which we received net proceeds of approximately $14.3 million. Concurrent with this transaction, we repurchased 3,333,333 shares of our common stock for an aggregate of $6.0 million. Our working capital at December 31, 2000 was $76.6 million compared to $81.7 million at December 31, 1999.

Our operating activities resulted in net cash inflows of $129,000 in 1998, $10.0 million in 1999 and $10.9 million in 2000. Cash provided by operating activities resulted primarily from income from operations (excluding acquired in-process research and development, amortization of intangible assets and the tax benefit from the exercise of stock options in 2000) and increases in deferred revenue, accounts payable and accrued liabilities, partially offset by increases in accounts receivable.

Investing activities used cash of $3.7 million in 1998, $32.8 million in 1999 and $30.0 million in 2000. Investing activities for 1998 were primarily purchases of capital equipment. Investing activities in 1999 included $25.8 million in purchases of short-term investments and $7.0 million in purchases of leasehold improvements and capital equipment primarily associated with the move to our corporate headquarters in Bellevue, Washington. Investing activities in 2000 included $14.3 million in net cash used in connection with the acquisition of Mainbrace Corporation, $8.5 million of cash used for the acquisition of smaller-scale companies and the purchase of strategic investments and $1.8 million of capital equipment purchases.

Financing activities generated $6.5 million in 1998, primarily through the issuance of mandatorily convertible preferred stock, partially offset by repayment of shareholder loans and the $6.0 million repurchase of shares of common stock. Financing activities in 1999 generated $72.9 million due to the net proceeds from the initial public offering and from the sale of common stock to Vulcan Ventures. Financing activities generated $3.3 million in 2000 due to proceeds from the issuance of shares under our employee stock purchase plan, the exercise of stock options and the exercise of warrants by former BlueWater Systems, Inc. shareholders.

We have a working capital revolving line of credit with Imperial Bank that is secured by our accounts receivable. This facility allows us to borrow up to the lesser of 80% of our eligible accounts receivable or $3.0 million and bears interest at the bank's prime rate, which was 9.0% at January 4, 2001. The facility expires in July 2001. The agreement, under which the line of credit was established contains certain covenants, including a provision requiring us to maintain specified financial ratios. We were in compliance with these covenants at December 31, 2000, and at that time there were no borrowings outstanding under this credit facility.

As of December 31, 2000, our principal commitments consisted of obligations outstanding under operating leases. We lease approximately 126,000 square feet in a single facility located in Bellevue, Washington pursuant to a lease, which expires in 2009. In September 2000, we signed a lease for approximately 20,000 square feet in Sunnyvale, California, which expires in December 2005. Additionally, we have lease commitments for office space in Eden Prairie, Minnesota, Tokyo, Japan and Munich, Germany. The annual cost of these leases is an aggregate of approximately $5.7 million, subject to annual adjustments. Although we have no other material commitments, we anticipate an increase in our capital expenditures and lease commitments consistent with our anticipated growth in our operations, infrastructure and personnel.

The rate of growth of our revenue over the prior year was 63% from 1997 to 1998, 60% from 1998 to 1999 and 53% from 1999 to 2000. The rate of growth of our revenue over prior periods may continue to decline. We currently anticipate that we will continue to experience significant increases in our operating expenses for the foreseeable future as we enter new markets for our products and services, increase research and development activities and sales and marketing activities, develop new distribution channels and broaden our professional service capabilities. These efforts may prove more expensive than we currently anticipate, and we may not succeed in increasing our revenue sufficiently to offset these higher expenses. If we fail to increase our revenue to keep pace with our expenses, we may experience losses.

We believe that our existing cash and cash equivalents and available bank borrowings will be sufficient to meet our anticipated cash needs for working capital and capital expenditures for at least the next 12 months. We believe that we will be able to meet our anticipated cash needs after that time from cash generated from operations and do not currently anticipate the need to raise additional capital. If we do seek to raise additional capital, there can be no assurance that additional financing will be available on acceptable terms, if at all. We may use a portion of our available cash to acquire additional businesses, products and technologies or to establish joint ventures that we believe will complement our current or future business. Pending such uses, we will invest our surplus cash in government securities and other short-term, investment grade, interest-bearing instruments.

### → Recent Accounting Pronouncements

In June 1998, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 133, "Accounting for Derivative Instruments and Hedging Activities." This statement requires that all derivative instruments be recorded on the balance sheet at their fair value. Changes in the fair value of derivatives are recorded each period in current earnings or other comprehensive income, depending on whether a derivative is designated as a part of a hedge transaction and, if it is the type of hedge transaction. Subsequent to the issuance of SFAS No. 133, the FASB received multiple requests for clarification of certain implementation issues. In June 2000, the FASB issued SFAS No. 138, responding to those requests by amending certain provisions of SFAS No. 133.

These amendments include allowing foreign currency denominated assets and liabilities to qualify for hedge accounting, permitting the offsetting of certain inter-entity foreign currency exposures that reduce the need for third-party derivatives and redefining the nature of interest rate risk to avoid sources of ineffectiveness. The Company will adopt SFAS No. 133 effective January 1, 2001. The Company does not expect that the adoption of this statement will have a material impact on our financial position or results of operations. The impact of this statement on future periods is unknown, but could result in increased volatility in our earnings and other comprehensive income.



## Report of Independent Public Accountants

To BSQUARE Corporation:

We have audited the accompanying consolidated balance sheets of BSQUARE Corporation and subsidiaries as of December 31, 2000 and 1999, and the related consolidated statements of income and comprehensive income, shareholders' equity and cash flows for each of the three years in the period ended December 31, 2000. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of BSQUARE Corporation and subsidiaries as of December 31, 2000 and 1999, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2000, in conformity with accounting principles generally accepted in the United States.

Arthur Andersen LLP

Seattle, Washington,
January 19, 2001

## Consolidated Balance Sheets

in thousands, except share amounts

| December 31, | 1999 | 2000 |
|---|---|---|
| **Assets** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 55,604 | $ 39,566 |
| Short-term investments | 27,368 | 32,785 |
| Accounts receivable, net of allowance for doubtful accounts of $142 in 1999 and $502 in 2000 | 4,302 | 12,617 |
| Income taxes receivable | 274 | 1,814 |
| Prepaid expenses and other current assets | 609 | 1,395 |
| Deferred income tax asset | 1,035 | 1,945 |
| Total current assets | 89,192 | 90,122 |
| Furniture, equipment and leasehold improvements, net | 7,238 | 5,640 |
| Investments | – | 4,628 |
| Goodwill and other intangible assets, net | – | 20,956 |
| Deposits and other assets | 212 | 916 |
| Total assets | $ 96,642 | $122,262 |
| **Liabilities and Shareholders' Equity** | | |
| Current liabilities: | | |
| Accounts payable | $ 654 | $ 725 |
| Accrued compensation | 2,352 | 3,596 |
| Accrued expenses | 3,381 | 4,511 |
| Deferred income taxes | – | 1,078 |
| Deferred revenue | 1,130 | 3,652 |
| Total current liabilities | 7,517 | 13,562 |
| Long-term obligations, net of current portion | – | 353 |
| Total liabilities | 7,517 | 13,915 |
| Commitments and contingencies (Note 7) | | |
| Shareholders' equity: | | |
| Series A Preferred Stock, no par value: Authorized 10,000,000; no shares issued and outstanding | – | – |
| BlueWater Systems, Inc. Series A Preferred Stock, no par value: Authorized 500,000 shares; 46,246 shares issued and outstanding in 1999; no shares outstanding in 2000 | 250 | – |
| Common stock, no par value: Authorized 50,000,000 shares, issued and outstanding, 32,509,978 shares in 1999, 33,975,187 shares in 2000 | 90,845 | 109,268 |
| Deferred stock option compensation | (868) | (314) |
| Cumulative foreign currency translation adjustment | (15) | (254) |
| Accumulated deficit | (1,087) | (353) |
| Total shareholders' equity | 89,125 | 108,347 |
| Total liabilities and shareholders' equity | $ 96,642 | $122,262 |

See notes to Consolidated Financial Statements.



## Consolidated Statement of Income and Comprehensive Income

in thousands, except per share amounts

| Year Ended December 31, | 1998 | 1999 | 2000 |
|---|---|---|---|
| Revenue: | | | |
| Service | $ 23,695 | $ 38,823 | $ 57,196 |
| Product | 2,242 | 2,583 | 6,306 |
| Total revenue | 25,937 | 41,406 | 63,502 |
| Cost of revenue: | | | |
| Service | 11,037 | 18,980 | 28,195 |
| Product | 326 | 529 | 1,591 |
| Total cost of revenue | 11,363 | 19,509 | 29,786 |
| Gross profit | 14,574 | 21,897 | 33,716 |
| Operating expenses: | | | |
| Research and development | 4,438 | 7,506 | 9,259 |
| Selling, general and administrative | 6,825 | 11,935 | 16,675 |
| Acquired in-process research and development | – | – | 4,100 |
| Amortization of intangible assets | – | – | 2,920 |
| Amortization of deferred stock option compensation | 171 | 583 | 554 |
| Total operating expenses | 11,434 | 20,024 | 33,508 |
| Income from operations | 3,140 | 1,873 | 208 |
| Other income (expense), net: | | | |
| Investment income, net | 326 | 926 | 3,282 |
| Acquisition related expense | – | – | (620) |
| Total other income (expense) | 326 | 926 | 2,662 |
| Income before income taxes | 3,466 | 2,799 | 2,870 |
| Provision for income taxes | 1,166 | 1,104 | 2,136 |
| Net income | $ 2,300 | $ 1,695 | $ 734 |
| Foreign currency translation | 5 | (20) | (239) |
| Comprehensive income | $ 2,305 | $ 1,675 | $ 495 |
| Basic earnings per share | $ 0.12 | $ 0.08 | $ 0.02 |
| Weighted average shares outstanding used to compute basic earnings per share | 18,633 | 21,430 | 33,275 |
| Diluted earnings per share | $ 0.08 | $ 0.06 | $ 0.02 |
| Weighted average shares outstanding to compute diluted earnings per share | 27,736 | 30,800 | 35,932 |

See notes to Consolidated Financial Statements.

## Consolidated Statements of Shareholders' Equity

in thousands, except share amounts

| | Preferred Stock Shares | Preferred Stock Amount | Common Stock Shares | Common Stock Amount | Deferred Stock Option Compensation | Foreign Currency Translation Adjustment | Retained Earnings (Accumulated Deficit) | Cumulative Total Shareholders' Equity (Deficit) |
|---|---|---|---|---|---|---|---|---|
| Balance, December 31, 1997 | – | $ – | 21,590,145 | $ 2,769 | $ (572) | $ – | $ 466 | $ 2,663 |
| Repurchase of common stock | – | – | (3,333,333) | (649) | – | – | (5,351) | (6,000) |
| Exercise of stock options | – | – | 119,938 | 6 | – | – | – | 6 |
| Compensation attributable to stock option vesting | – | – | – | – | 171 | – | – | 171 |
| Foreign currency translation adjustment | – | – | – | – | – | 5 | – | 5 |
| Accretion on mandatorily redeemable convertible preferred stock | – | – | – | – | – | – | (110) | (110) |
| Net income | – | – | – | – | – | – | 2,300 | 2,300 |
| Balance, December 31, 1998 | – | – | 18,376,750 | 2,126 | (401) | 5 | (2,695) | (965) |
| Exercise of stock options | – | – | 281,517 | 77 | – | – | – | 77 |
| Issuance of compensatory stock options | – | – | – | 1,050 | (1,050) | – | – | – |
| Compensation attributable to stock option vesting | – | – | – | – | 583 | – | – | 583 |
| Foreign currency translation adjustment | – | – | – | – | – | (20) | – | (20) |
| Accretion on mandatorily redeemable convertible preferred stock | – | – | – | – | – | – | (87) | (87) |
| Issuance of BlueWater Systems Series A Preferred Stock | 46,246 | 250 | – | – | – | – | – | 250 |
| Issuance of common stock (net of offering costs of $13) | – | – | 1,518,378 | 18,689 | – | – | – | 18,689 |
| Issuance of common stock in connection with the initial public offering (net of offering costs of $5,601) | – | – | 4,000,000 | 54,399 | – | – | – | 54,399 |
| Conversion of mandatorily redeemable convertible preferred stock into shares of common stock | – | – | 8,333,333 | 14,504 | – | – | – | 14,504 |
| Net income | – | – | – | – | – | – | 1,695 | 1,695 |
| Balance, December 31, 1999 | 46,246 | 250 | 32,509,978 | 90,845 | (868) | (15) | (1,087) | 89,125 |
| Exercise of stock options, warrants and employee stock purchase plan | – | – | 712,680 | 3,350 | – | – | – | 3,350 |
| Compensation attributable to stock option vesting | – | – | – | – | 554 | – | – | 554 |
| Foreign currency translation adjustment | – | – | – | – | – | (239) | – | (239) |
| Conversion of preferred stock into common stock | (46,246) | (250) | 46,246 | 250 | – | – | – | – |
| Issuance of common stock upon acquisition of Mainbrace Corporation | – | – | 627,334 | 9,650 | – | – | – | 9,650 |
| Issuance of common stock upon acquisition of company | – | – | 78,949 | 1,441 | – | – | – | 1,441 |
| Tax benefit from exercise of stock options | – | – | – | 3,732 | – | – | – | 3,732 |
| Net income | – | – | – | – | – | – | 734 | 734 |
| Balance, December 31, 2000 | – | $ – | 33,975,187 | $ 109,268 | $ (314) | $ (254) | $ (353) | $ 108,347 |

See notes to Consolidated Financial Statements.

# Consolidated Statements of Cash Flows

in thousands

| Year Ended December 31, | 1998 | 1999 | 2000 |
|---|---|---|---|
| Cash flows from operating activities: | | | |
| Net income | $ 2,300 | $ 1,695 | $ 734 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Depreciation and amortization | 995 | 2,264 | 5,422 |
| In-process research and development | – | – | 4,100 |
| Other | – | – | 250 |
| Deferred income taxes | (397) | (925) | 168 |
| Tax benefit from exercise of stock options | – | – | 3,732 |
| Stock and stock option compensation | 171 | 583 | 554 |
| Amortization of deferred financing costs | 14 | 13 | 10 |
| Changes in operating assets and liabilities, net of effects of acquisition: | | | |
| Accounts receivable, net | (2,795) | 1,309 | (7,113) |
| Prepaid expenses and other current assets | (116) | (123) | (784) |
| Deposits and other assets | (117) | (19) | (534) |
| Accounts payable and accrued expenses | 1,050 | 4,387 | 3,450 |
| Income taxes | (389) | (144) | (1,539) |
| Deferred revenue | (587) | 952 | 2,461 |
| Net cash provided by operating activities | 129 | 9,992 | 10,911 |
| Cash flows from investing activities: | | | |
| Purchases of furniture equipment and leasehold improvements | (2,149) | (7,035) | (1,757) |
| Purchase of short-term investments, net | (1,582) | (25,785) | (5,415) |
| Purchase of Mainbrace Corporation, net of cash acquired | – | – | (14,294) |
| Acquisition of companies, net of cash acquired | – | – | (3,633) |
| Purchase of investments | – | – | (4,878) |
| Net cash used in investing activities | (3,731) | (32,820) | (29,977) |
| Cash flows from financing activities: | | | |
| Repayment of shareholder notes payable | (1,743) | – | – |
| Payments on long-term obligations | (27) | (453) | (66) |
| Repurchase of common stock | (6,000) | – | – |
| Deferred financing costs | (2) | (25) | (8) |
| Proceeds from exercise of stock options, warrants and employee stock purchase plan | 6 | 77 | 3,350 |
| Net proceeds from issuance of mandatorily redeemable Series A Preferred Stock | 14,307 | – | – |
| Net proceeds from issuance of BlueWater Systems Series A Preferred Stock | – | 250 | – |
| Net proceeds from sale of common stock | – | 18,689 | – |
| Proceeds from sale of initial public offering | – | 54,399 | – |
| Net cash provided by financing activities | 6,541 | 72,937 | 3,276 |
| Effect of exchange rate changes on cash | 7 | 21 | (248) |
| Net increase (decrease) in cash and cash equivalents | 2,946 | 50,130 | (16,038) |
| Cash and cash equivalents, beginning of period | 2,528 | 5,474 | 55,604 |
| Cash and cash equivalents, end of period | $ 5,474 | $ 55,604 | $ 39,566 |

See notes to Consolidated Financial Statements.



# Notes to Consolidated Financial Statements

in thousands, except share and per share amounts

## Note one
## Summary of Significant Accounting Policies

**Description of Business**

BSQUARE Corporation, a Washington corporation, and its subsidiaries (collectively the Company) provides a variety of software products and services that enable the creation and deployment of a wide variety of intelligent computing devices based on Microsoft Windows-based operating systems. The Company works with semiconductor vendors and original equipment manufacturers to provide software products and engineering services for the development of intelligent computing devices.

The Company helps enable the rapid and low-cost development of intelligent computing devices by providing a variety of software products and services for the design, integration and deployment of Windows-based operating systems with industry-specific applications. The Company also develops software applications that are licensed to original equipment manufacturers (OEMs) and end users to provide intelligent computing devices with additional functionality. The Company markets and supports its products and provides services on a worldwide basis through a direct sales force augmented by distributors.

**Certain Significant Risks and Uncertainties**

The Company operates in the software industry, and accordingly, can be affected by a variety of factors. For example, management of the Company believes that any of the following factors could have a significant negative effect on the Company's future financial position, results of operations and cash flows: unanticipated fluctuations in quarterly operating results; failure of the market for Windows CE operating system to develop fully; failure of the market for intelligent computing devices to develop fully; adverse changes in the Company's relationship with Microsoft; failure to secure contracts with market-leading original equipment manufacturers; intense competition; failure to attract and retain key personnel; failure to protect intellectual property; risks associated with international operations; inability to manage growth; and litigation or other claims against the Company.

**Basis of Presentation**

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. Significant intercompany accounts and transactions have been eliminated. Accounts denominated in foreign currencies have been re-measured to the U.S. dollar from the functional currency.

On January 5, 2000, the Company acquired BlueWater Systems, Inc. in a transaction accounted for as a pooling of interests. The consolidated financial statements and notes thereto have been restated for all periods presented to include the accounts and operations of BlueWater Systems, Inc. as if it had always been a part of BSQUARE.

#### Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

#### Earnings Per Share

In accordance with Statement of Financial Accounting Standards (SFAS) No. 128, "Computation of Earnings Per Share," basic earnings per share is computed by dividing net income available to common shareholders (net income less accretion of mandatorily redeemable convertible preferred stock) by the weighted average number of shares of common stock outstanding during the period. Dilutive earnings per share is computed by dividing net income by the weighted average number of common and dilutive common equivalent shares outstanding during the period. Common equivalent shares consist of the shares of common stock issuable upon the conversion of the mandatorily redeemable convertible preferred stock (using the if-converted method) and shares issuable upon the exercise of stock options and warrants (using the treasury stock method); common equivalent shares are excluded from the calculation if their effect is antidilutive. The Company has not had any issuances or grants for nominal consideration as defined under Staff Accounting Bulletin 98.

#### Cash and Cash Equivalents

Cash and cash equivalents include demand deposits, money market accounts and all highly liquid debt instruments with a purchased maturity date of three months or less.

#### Short-term Investments

The Company's short-term investments consist primarily of investment-grade marketable securities, which are classified as held to maturity and recorded at amortized cost. Due to the short-term nature of these investments, changes in market interest rates would not have a significant impact on the fair value of these securities that are carried at amortized cost, which approximates fair value.

At December 31, 1999 and 2000, all short-term investments had a contractual maturity of two years or less.

#### Financial Instruments and Concentrations of Credit Risk

The Company has the following financial instruments: cash and cash equivalents, short-term investments, accounts receivable, accounts payable, accrued liabilities, bank lines of credit and standby letters of credit. The carrying value of cash and cash equivalents, short-term investments, accounts receivable, accounts payable, and accrued liabilities approximate fair value based on the liquidity of these financial instruments



or based on their short term nature. The carrying value of notes payable, bank lines of credit, and standby letters of credit approximates fair value based on the market interest rates available to the Company for debt of similar risk and maturities.

The Company performs initial and ongoing evaluations of its customers' financial position, and generally extends credit on open account, requiring collateral as deemed necessary. The Company maintains allowances for potential credit losses.

#### Furniture, Equipment and Leasehold Improvements

Furniture, equipment and leasehold improvements are stated at cost less accumulated depreciation. Depreciation is provided on the straight-line method over the estimated useful lives, as follows: office furniture and equipment – four years; computer equipment – three years. Leasehold improvements are amortized over the shorter of the lease term or the estimated useful life. Maintenance and repairs are expensed as incurred. When properties are retired or otherwise disposed, gains or losses are reflected in the income statement. When facts and circumstances indicate that the cost of long-lived assets may be impaired, an evaluation of recoverability is performed by comparing the carrying value of the asset to projected future cash flows. Upon indication that the carrying value of such assets may not be recoverable, the Company would recognize an impairment loss by a charge against current operations.

#### Goodwill and Other Intangible Assets

Goodwill represents the excess of the purchase price over the fair value of identifiable tangible and intangible assets acquired and liabilities assumed in a business combination accounted for under the purchase accounting method. Goodwill and other intangible assets are amortized over their deemed useful lives, ranging from two to seven years.

#### Software Development Costs

Under the criteria set forth in Statement of Financial Accounting Standards No. 86, "Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed," capitalization of software development costs begins upon the establishment of technological feasibility of the product, which the Company has defined as the completion of beta testing of a working product. The establishment of technological feasibility and the ongoing assessment of the recoverability of these costs require considerable judgment by management with respect to certain external factors, including, but not limited to, anticipated future gross product revenue, estimated economic life and changes in software and hardware technology. Amounts that could have been capitalized under this statement after consideration of the above factors were immaterial and, therefore, no software development costs have been capitalized by the Company to date.

#### Research and Development

Research and development costs are expensed as incurred.

#### Income Taxes

The Company computes income taxes using the asset and liability method, under which deferred income taxes are provided for the temporary differences between the financial reporting basis and the tax basis of the Company's assets and liabilities. Deferred tax assets and liabilities are measured using currently enacted tax rates that are expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. A valuation allowance is established when necessary to reduce deferred tax assets to the amounts expected to be realized.

#### Foreign Currency Translation

The functional currency of foreign subsidiaries is the local currency. Accordingly, assets and liabilities are translated into U.S. dollars at exchange rates in effect at the balance sheet date and income and expense accounts at the average exchange rates during the year. Resulting translation adjustments are recorded as a separate component of shareholders' equity. The net gains and losses resulting from foreign currency transactions are recorded in the consolidated statements of income in the period incurred and were not significant for any of the periods presented.

#### Revenue Recognition

The Company's revenue recognition policy is in compliance with the provisions of the American Institute of Certified Public Accountants' Statement of Position 97-2, "Software Revenue Recognition." Service revenue is derived from software porting and development contracts. Product revenue consists of licensing fees from software application products and operating system and software development tool products. The Company's customers consist of software companies, original equipment manufacturers, distributors and end users.

In December 1999, the SEC issued Staff Accounting Bulletin ("SAB") 101, "Revenue Recognition," which outlines the basic criteria that must be met to recognize revenue and provides guidance for presentation of revenue and for disclosure related to revenue recognition policies in financial statements filed with the SEC. The Company believes that it is in compliance with the provisions of SAB 101.

Service revenue is derived from fees from professional services, porting and development contracts, software maintenance and support contracts, and customer training. Service revenue is recognized as follows:

> **TIME AND MATERIAL CONSULTING CONTRACTS** The Company recognizes revenue as services are rendered.

> **FIXED-PRICE CONSULTING CONTRACTS** Service revenue from fixed-price contracts is recognized on the percentage-of-completion method, measured by the cost incurred to date to the estimated total cost for the contract. This method is used as management considers expended costs to be the best available measure of contract performance. Contract costs include all direct labor, material and any other costs related to contract performance. Selling, general and administrative costs are charged to expense as incurred. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are determined. Changes in job performance, job conditions and estimated profitability may result in revisions in the estimate of total costs. Any required adjustments due to these changes are recognized in the period in which such revisions are determined.



> **SOFTWARE MAINTENANCE CONTRACTS** Software maintenance and support fees are recognized ratably over the contract period.

> **CUSTOMER TRAINING** Service revenue from training is recognized when the services are provided.

Product revenue consists of licensing fees from software development tool products and operating system licenses and royalty fees from embedded system run-time licenses. Product licensing fees, including advanced production royalty payments, are generally recognized when a customer license agreement has been executed, the software has been shipped, remaining obligations are insignificant and collection of the resulting account receivable is probable. The Company recognizes license royalty income as the reseller reports when it ships its product to distributors.

Deferred revenue consists of deposits received from customers for service contracts and unamortized service contract revenue.

#### Reclassifications

Certain prior year amounts have been reclassified to conform to the current year presentation.

## Note Two
## Cash and Short-term Investments

The Company's cash, cash equivalents and short-term investments consist of the following:

| December 31, | 1999 | 2000 |
|---|---|---|
| Cash and equivalents: | | |
| Cash | $ 665 | $ 1,737 |
| Money market funds | 8,056 | 1,721 |
| Municipal certificates | 46,883 | 29,200 |
| Commercial Paper | – | 1,899 |
| Corporates | – | 5,009 |
| | $ 55,604 | $ 39,566 |
| Short-term investments: | | |
| Commercial paper | $ 3,064 | $ 145 |
| Corporate notes and bonds | 12,580 | 10,781 |
| Municipal securities | 11,724 | 21,859 |
| | $ 27,368 | $ 32,785 |

## Note Three
### Furniture, Equipment and Leasehold Improvements

Major classifications of furniture, equipment and leasehold improvements consist of the following:

| December 31, | 1999 | 2000 |
|---|---|---|
| Computer equipment and system software | $ 3,707 | $ 4,992 |
| Office furniture and equipment | 1,282 | 1,460 |
| Leasehold improvements | 4,443 | 3,570 |
| Construction in progress | – | 98 |
| | 9,432 | 10,120 |
| Less: accumulated depreciation and amortization | (2,194) | (4,480) |
| | $ 7,238 | $ 5,640 |

## Note Four
### Goodwill and Other Intangible Assets

Major classifications goodwill and other intangible assets consist of the following:

| December 31, | 1999 | 2000 |
|---|---|---|
| Goodwill | $ – | $ 17,395 |
| Non-compete agreements | – | 4,581 |
| Developed technology | – | 1,600 |
| Assembled workforce | – | 300 |
| | $ – | $ 23,876 |
| Less: accumulated depreciation and amortization | – | (2,920) |
| | $ – | $ 20,956 |



## Note Five
### Income Taxes

The Company was a Subchapter S Corporation for income tax purposes from inception to October 15, 1997. Effective October 16, 1997, the Company converted to a C Corporation and was thereafter responsible for U.S. federal income taxes. A net deferred tax liability of $445, primarily related to the required conversion for income tax purposes from the cash basis method to the accrual basis method of accounting, was recorded at the conversion date to reflect the Company's net taxable temporary differences.

The provision for income taxes consisted of the following:

| Year Ended December 31, | 1998 | 1999 | 2000 |
|---|---|---|---|
| Current: | | | |
| U.S. Current | $ 1,536 | $ 2,001 | $ 2,378 |
| International | 27 | 28 | 27 |
| U.S. Deferred | (397) | (925) | (269) |
| Total tax provision | $ 1,166 | $ 1,104 | $ 2,136 |

The components of net deferred tax assets (liabilities) consisted of the following:

| December 31, | 1999 | 2000 |
|---|---|---|
| Deferred income tax asset: | | |
| Depreciation and amortization | $ 88 | $ 101 |
| Accrued compensation and benefits | 472 | 772 |
| Deferred revenue | 213 | 255 |
| Cash to accrual basis conversion | (111) | – |
| Allowance for doubtful accounts | 48 | 174 |
| Acquired net operating losses | – | 327 |
| Other, net | 325 | 316 |
| | $ 1,035 | $ 1,945 |
| Deferred income tax liability: | | |
| Acquired intangible assets | $ – | $ (955) |
| Other, net | – | (123) |
| | $ – | $ (1,078) |

The provision for income taxes differs from the amount of income tax determined by applying the applicable U.S. statutory federal income tax rate to pre-tax income, as a result of the following:

| Year Ended December 31, | 1998 | 1999 | 2000 |
|---|---|---|---|
| Taxes at the U.S. statutory rate | 34.0% | 34.0% | 34.0% |
| Increase (decrease) in income taxes resulting from: | | | |
| Research and development tax credit | (6.2) | (7.2) | (16.5) |
| International operations | 4.5 | 14.3 | 19.7 |
| Tax exempt interest | – | (5.5) | (32.3) |
| Acquisition expenses | – | – | 3.9 |
| Acquired in-process research and development | – | – | 50.0 |
| Amortization of intangible assets | – | – | 19.7 |
| Other, net | 1.3 | 3.8 | (4.1) |
| | 33.6% | 39.4% | 74.4% |

## Note Six
### Bank Line of Credit

At December 31, 2000, the Company had available a $3.0 million secured domestic revolving line of credit, with interest accruing at the bank's prime rate. Restrictive terms of the lines require, among other requirements, that the Company maintain a minimum quick ratio, tangible net worth and debt service ratio, and limits the Company's ability to pay dividends without the lender's consent. The line of credit is secured by substantially all of the assets of the Company. As of December 31, 2000 the Company had $1.2 million in standby letters of credit issued and outstanding under the domestic revolving line of credit.

## Note Seven
### Commitments and Contingencies

The Company leases its office space under non-cancelable operating leases that expire at various dates through 2009. During the years ending December 31, 1998, 1999 and 2000, rental expense was $980, $3,347 and $4,654, respectively. Minimum rental commitments under non-cancelable operating leases at December 31, 2000 are as follows:

| | |
|---|---|
| 2001 | $ 5,720 |
| 2002 | 5,688 |
| 2003 | 5,805 |
| 2004 | 5,693 |
| 2005 | 3,186 |
| Thereafter | 18,479 |
| | $ 44,571 |



The Company's corporate headquarters are located in a single location in Bellevue, Washington. The Company has the option to extend the lease for four additional periods of five years each. The Company has provided a $1.2 million stand-by letter of credit as security for this lease which may be reduced annually by specified amounts in the lease agreement.

## Note Eight
### Shareholders' Equity

**Initial Public Offering**

On October 20, 1999, the Company issued 4,000,000 shares of its common stock at an initial public offering price of $15.00 per share. Also sold in this offering were 600,000 shares held by selling shareholders upon exercise of the underwriters' overallotment option. The net proceeds to the Company from the offering, net of offering costs of approximately $5.6 million, were approximately $54.4 million. Concurrent with the initial public offering, each outstanding share of the Company's mandatorily redeemable preferred stock was automatically converted into common stock.

**Stock Purchase Agreement**

On August 18, 1999, the Company entered into a stock purchase agreement to sell 1,518,378 shares of common stock to Vulcan Ventures for approximately $18.7 million.

**Common Stock Reserved For Future Issuance**

At December 31, 2000, the Company had reserved the following shares of common stock for future issuance:

| | |
|---|---|
| BSQUARE Employee Stock Purchase Plan | 1,317,038 |
| BSQUARE Stock Option Plan | 2,393,016 |

## Note Nine
## Employee Benefit Plans

**Stock Options**

In May 1997, the Company adopted the Amended and Restated Stock Option Plan (the Plan). Under the Plan, the Board of Directors may grant nonqualified stock options at a price determined by the Board, not to be less than 85% of the fair market value of the common stock. Options have a term of up to 10 years and vest over a schedule determined by the Board of Directors, generally four years. Incentive stock options granted under this program may only be granted to employees of the Company, have a term of up to 10 years, and shall be granted at a price equal to the fair market value of the Company's stock.

The Company has assumed certain options granted to employees of acquired companies, referred to as acquired options. These options were assumed by the Company outside of its stock option plans, and are administered as if issued under their original plans. All of the acquired options have been adjusted to reflect the price conversion under the terms of the agreements between the Company and the companies acquired. The acquired options generally become exercisable over a four-year period and generally expire ten years from the date of grant. No additional options will be granted under any of the acquired companies' plans.

A summary of stock option activity follows:

| | Number of Options Outstanding | Available for Issuance | Price Per Share: Weighted Average Exercise Price | Price Per Share: Range |
|---|---|---|---|---|
| Balance, December 31, 1997 | 1,680,800 | 819,200 | $ 0.08 | $ 0.05 – $ 1.00 |
| Authorized | – | 1,125,000 | – | – |
| Granted | 1,108,150 | (1,108,150) | $ 1.15 | $ 1.00 – $ 1.80 |
| Exercised | (119,938) | – | $ 0.05 | $ 0.05 – $ 0.05 |
| Canceled | (128,850) | 128,850 | $ 0.34 | $ 0.05 – $ 1.00 |
| Balance, December 31, 1998 | 2,540,162 | 964,900 | $ 0.54 | $ 0.05 – $ 1.80 |
| Authorized | – | 2,000,000 | – | – |
| Granted | 1,345,795 | (1,345,795) | $ 7.24 | $ 1.44 – $ 45.06 |
| Exercised | (281,517) | – | $ 0.36 | $ 0.05 – $ 1.00 |
| Canceled | (154,875) | 154,875 | $ 0.82 | $ 0.05 – $ 10.00 |
| Balance, December 31, 1999 | 3,449,565 | 1,773,980 | $ 3.15 | $ 0.05 – $ 45.06 |
| Authorized | – | 1,771,786 | – | – |
| Assumption of acquired company options | 194,422 | (194,422) | $ 1.92 | $ 0.07 – $ 3.11 |
| Granted | 1,512,124 | (1,512,124) | $ 19.05 | $ 6.00 – $ 49.69 |
| Exercised | (529,718) | – | $ 0.86 | $ 0.05 – $ 11.64 |
| Canceled | (553,796) | 553,796 | $ 10.55 | $ 0.05 – $ 45.06 |
| Balance, December 31, 2000 | 4,072,597 | 2,393,016 | $ 8.58 | $ 0.05 – $ 49.69 |



The following table summarizes information concerning currently outstanding and exercisable options at December 31, 2000:

| Range of Exercise Price | Outstanding: Number of Options | Outstanding: Weighted Average Remaining Contractual Life (Years) | Exercisable: Number of Options | Exercisable: Weighted Average Exercise Price |
|---|---|---|---|---|
| $ 0.05 – $ 10.00 | 2,469,347 | 7.1 | 1,304,231 | $ 1.44 |
| $ 12.00 – $ 20.00 | 1,394,500 | 9.3 | 51,325 | 12.00 |
| $ 2.25 – $ 39.99 | 55,650 | 9.3 | 1,500 | 35.39 |
| $ 40.00 – $ 49.69 | 153,100 | 9.0 | 1,250 | 43.53 |
| | 4,072,597 | 8.2 | 1,358,306 | $ 1.93 |

Had compensation expense been recognized on stock options issued based on the fair value of the options at the date of the grant and recognized over the vesting period, the Company's net income would have been reduced to the pro forma amounts presented below:

| Year Ended December 31, | 1998 | 1999 | 2000 |
|---|---|---|---|
| Net income, as reported | $ 2,300 | $ 1,695 | $ 734 |
| Supplemental pro forma compensation expense under SFAS 123 | (82) | (1,351) | (3,342) |
| Pro forma net income (loss) | $ 2,218 | $ 344 | $ (2,608) |
| Pro forma basic earnings (loss) per share | $ 0.12 | $ 0.01 | $ (0.08) |
| Pro forma diluted earnings (loss) per share | $ 0.08 | $ 0.01 | $ (0.08) |

The fair value of options granted in 1998, 1999 and 2000 of $0.25, $4.89 and $3.58, respectively, has been estimated at the date of grant using the Black-Scholes method with the following weighted-average assumptions:

| Year Ended December 31, | 1998 | 1999 | 2000 |
|---|---|---|---|
| Dividend yield | 0% | 0% | 0% |
| Expected life (years) | 5 | 5 | 5 |
| Expected volatility | 0% | 57% | 70% |
| Risk-free interest rate | 5.5% | 6.6% | 5.7% |

The effects on pro forma disclosures of applying SFAS No. 123 are not likely to be representative of the effects on pro forma disclosures of future years.

### 1999 Employee Stock Purchase Plan

On July 21, 1999, the Board of Directors approved the adoption of the Company's 1999 Employee Stock Purchase (the "1999 Purchase Plan".) Under the 1999 Purchase Plan, the Company is authorized to sell up to 1,500,000 shares of common stock in a series of eighteen month offerings. The 1999 Purchase Plan permits eligible employees to acquire shares of the Company's common stock through periodic payroll deductions of up to 10% of base cash compensation. The price at which the common stock may be purchased is 85% of the lesser of 1) the fair market value of the Company's common stock on the first day of the applicable offering period or 2) the fair market value of the shares on the purchase date. The initial offering period commenced on the effectiveness of the initial public offering. During the twelve months ended December 31, 2000, the Company issued 182,962 shares under the plan.

### Profit Sharing and Deferred Compensation Plan

The Company has a Profit Sharing and Deferred Compensation Plan (Profit Sharing Plan) under Section 401(k) of the Internal Revenue Code of 1986, as amended. Substantially all full-time employees are eligible to participate. The Company, at its discretion, may elect to match the participants' contributions to the Profit Sharing Plan. Participants will receive their share of the value of their investments upon retirement or termination, subject to a vesting schedule. The Company made no matching contributions to the Profit Sharing Plan during 1998. During the years ended December 31, 1999 and 2000, the Company made matching contributions to the Profit Sharing Plan of $514 and $760 respectively.

### Deferred Stock Option Compensation

In connection with the grant of certain stock options to employees and consultants during 1999, the Company recorded deferred stock option compensation of $1.1 million, representing the difference between the estimated fair value of the common stock for accounting purposes and the option exercise price of such options at the date of grant. Such amount is presented as a reduction of shareholders' equity and amortized, in accordance with FASB Interpretation No. 28, on an accelerated basis over the vesting period of the applicable options (generally four years). During the years ended December 31, 1998, 1999 and 2000, the Company expensed approximately $171, $583 and $554, respectively. The balance will be expensed over the period the options vest. Compensation expense is decreased in the period of forfeiture for any accrued but unvested compensation arising from the early termination of an option holder's services.

Included in the expensed amounts noted above for the year ended December 31, 1999 is $30 related to options granted to a consultant for services rendered. As of December 31, 1999, the consultant had earned 20,833 options to acquire common stock at $1 per share. The Company has recorded the fair value of the options as of the date the options were earned based on a Black-Scholes model utilizing a 50% volatility factor and an expected life of 2 years. The agreement was terminated in 1999.



## Note Ten
## Supplemental Disclosure of Cash Flow Information

| Year Ended December 31, | 1998 | 1999 | 2000 |
|---|---|---|---|
| Issuance of notes payable for equipment | $ 473 | $ – | $ – |
| Cash paid for interest | 57 | 68 | 38 |
| Cash paid for income taxes | 2,170 | 2,520 | 1,050 |
| Common stock issued for acquisition of BlueWater Systems Inc. | – | – | 11,044 |
| Common stock issued for acquisition of Mainbrace Corporation | – | – | 9,650 |
| Common stock issued for acquisition | – | – | 1,441 |

All significant non-cash financing activities are listed elsewhere in the financial statements or the notes thereto.

## Note Eleven
## Significant Customers

For the years ended December 31, 1998, 1999 and 2000, approximately 75%, 85% and 58% of our revenue, respectively, was generated under our master development and license agreement with Microsoft. The master agreement, the current term of which concludes in July 2001, includes a number of project-specific work plans. As of December 31, 1998, 1999 and 2000, Microsoft represented 84%, 82% and 52% of total accounts receivable, respectively.

## Note Twelve
### Geographic and Segment Information

The Company follows the requirements of Statement of Financial Accounting Standards No. 131 (SFAS 131), Disclosures About Segments of an Enterprise and Related Information. As defined in SFAS No. 131, the Company operates in two reportable segments, Service and Product for Windows-based operating systems. The following table summarizes total revenue and long-lived assets attributed to significant countries:

| Year Ended December 31, | 1998 | 1999 | 2000 |
|---|---|---|---|
| Total revenue: | | | |
| United States | $ 24,698 | $ 39,876 | $ 49,989 |
| Japan | 480 | 671 | 8,272 |
| Other Foreign | 759 | 859 | 5,241 |
| Total revenue[1] | $ 25,937 | $ 41,406 | $ 63,502 |
| Long-lived assets: | | | |
| United States | $ 2,886 | $ 7,036 | $ 5,681 |
| Japan | 239 | 257 | 793 |
| Germany | 205 | 157 | 82 |
| Total long-lived assets[2] | $ 3,330 | $ 7,450 | $ 6,556 |

1 Revenue is attributed to countries based on location of customer invoiced.

2 Long-lived assets do not include acquired intangible assets and goodwill.

BSQUARE has two operating segments, Service and Product. The Service segment includes design and development of integration tools for the semiconductor vendors and the original equipment manufacturer market. The Product segment derives revenue from licensing of software products to original equipment manufactures and distributing product through resellers. The accounting policies of the segments are the same as those described in the summary of significant accounting policies.

The Company does not track assets or operating expenses by operating segments. Consequently, it is not practicable to show assets or operating expenses by operating segments.



## Note Thirteen
### Quarterly Financial Information (Unaudited)

Summarized quarterly financial information for 1999 and 2000 are as follows:

| | Mar 31 | Jun 30 | Sep 30 | Dec 31 |
|---|---|---|---|---|
| **1999 Quarter Ended** | | | | |
| Revenue | $ 9,167 | $ 10,094 | $ 10,449 | $ 11,696 |
| Gross profit | 4,982 | 5,400 | 5,461 | 6,054 |
| Income (loss) from operations | 719 | 731 | 460 | (37) |
| Net income | $ 429 | $ 442 | $ 378 | $ 446 |
| Earnings per share, basic | $ 0.02 | $ 0.02 | $ 0.02 | $ 0.01 |
| Weighted average shares outstanding used to compute basic earnings per share | 18,458 | 18,476 | 18,844 | 31,655 |
| Earnings per share, diluted | $ 0.02 | $ 0.02 | $ 0.01 | $ 0.01 |
| Weighted average shares outstanding used to compute diluted earnings per share | 28,468 | 29,145 | 29,800 | 32,800 |
| **2000 Quarter Ended** | | | | |
| Revenue | $ 13,292 | $ 15,700 | $ 16,641 | $ 17,869 |
| Gross profit | 6,943 | 8,279 | 8,850 | 9,644 |
| Income (loss) from operations | 1,208 | (2,873) | 822 | 1,051 |
| Net income (loss) | $ 995 | $ (2,475) | $ 1,252 | $ 962 |
| Earnings (loss) per share, basic | $ 0.03 | $ (0.07) | $ 0.04 | $ 0.03 |
| Weighted average shares outstanding used to compute basic earnings (loss) per share | 32,566 | 33,076 | 33,605 | 33,847 |
| Earnings (loss) per share, diluted | $ 0.03 | $ (0.07) | $ 0.03 | $ 0.03 |
| Weighted average shares outstanding used to compute diluted earnings per share | 35,628 | 33,076 | 36,222 | 35,946 |

## Note Fourteen
## Earnings Per Share

The following is a reconciliation of the numerators and denominators used in computing basic and diluted earnings per share:

| Year Ended December 31, | 1998 | 1999 | 2000 |
|---|---|---|---|
| Net income (numerator diluted) | $ 2,300 | $ 1,695 | $ 734 |
| Less: Accretion of mandatorily redeemable convertible preferred stock | (110) | (87) | – |
| Net income available to common shareholders (numerator basic) | $ 2,190 | $ 1,608 | $ 734 |
| Shares (denominator basic): | | | |
| Weighted average common shares outstanding | 18,633 | 21,430 | 33,275 |
| Basic earnings per share | $ 0.12 | $ 0.08 | $ 0.02 |
| Shares (denominator diluted): | | | |
| Weighted average common shares outstanding[1] | 18,633 | 21,430 | 33,275 |
| Mandatorily redeemable convertible preferred stock | 7,648 | 6,689 | – |
| Common stock equivalents | 1,455 | 2,681 | 2,657 |
| Shares used in computation (denominator diluted) | 27,736 | 30,800 | 35,932 |
| Diluted earnings per share | $ 0.08 | $ 0.06 | $ 0.02 |

1 Share amounts presented for 1998 to 1999 give effect to the issuance of 261,391 shares to the former shareholders of BlueWater Systems to effect its acquisition by BSQUARE. The transaction was accounted for as a pooling of interests.

## Note Fifteen
## Acquisitions

**BlueWater Systems, Inc.**

On January 5, 2000, the Company acquired BlueWater Systems, Inc. in a transaction accounted for as a pooling of interests. BlueWater Systems, formerly located in Edmonds, Washington, is dedicated to the design of software development tool kits and system integration services for the creation of Windows-based intelligent computing devices. The transaction was effected through the exchange of 261,391 shares of BSQUARE common stock for all of the issued and outstanding common shares of BlueWater Systems. The consolidated financial statements of BSQUARE have been restated for all periods prior to the merger to include the accounts and operations of BlueWater Systems, Inc. In connection with the acquisition, the Company incurred $620 ($515 after taxes, or $0.01 per diluted share) of acquisition-related costs which were charged to operations during the three months ended March 31, 2000.

The following table presents a reconciliation of revenue and net income previously reported by BSQUARE to those presented in the accompanying condensed consolidated financial statements:

| Year Ended December 31, | 1998 | 1999 |
|---|---|---|
| Revenue: | | |
| BSQUARE Corporation | $ 24,612 | $ 39,938 |
| BlueWater Systems, Inc. | 1,325 | 1,468 |
| Combined | $ 25,937 | $ 41,406 |
| Net income: | | |
| BSQUARE Corporation | $ 2,300 | $ 1,691 |
| BlueWater Systems, Inc. | – | 4 |
| Combined | $ 2,300 | $ 1,695 |

**Mainbrace Corporation**

On May 24, 2000, the Company acquired Mainbrace Corporation in a transaction accounted for as a purchase. Mainbrace Corporation, located in Sunnyvale, California, is a leading IP-licensing and enabling software firm delivering product solutions to high volume market segments including set-top boxes, Web-enabled phones, wireless thin clients, and electronic book readers. Total consideration included the issuance of 627,334 shares of BSQUARE common stock, and approximately $10,800 in cash. Additionally, the Company assumed Mainbrace's outstanding vested and unvested employee stock options, which were converted into the right to acquire an additional 172,629 shares of the Company's common stock. Such assumption of Mainbrace's options by the Company had a fair market value of approximately $552.

A summary of the purchase price for the acquisition is as follows:

| | |
|---|---|
| Cash | $ 10,800 |
| Stock and stock options | 9,650 |
| Direct acquisition costs | 347 |
| Other acquisition costs | 2,840 |
| Net deferred tax liability | 319 |
| Assumed debt | 900 |
| Total | $ 24,856 |

The purchase price was allocated as follows:

| | |
|---|---|
| Working capital acquired | $ 871 |
| Equipment | 160 |
| Goodwill | 16,885 |
| Intangible assets | 2,840 |
| In-process research and development | 4,100 |
| Total | $ 24,856 |

The excess of consideration paid over the fair value of the net assets acquired was recorded as goodwill and other intangible assets and is amortized over periods ranging from two to seven years.

In accordance with generally accepted accounting principles, the amount allocated to in-process research and development, which was determined by an independent valuation, has been recorded as a charge to expense in the second quarter of 2000 because its technological feasibility had not been established and it had no alternative future use at the date of acquisition.

The following table presents unaudited pro forma results of operations as if the acquisition of Mainbrace had occurred at the beginning of each of the periods presented. The unaudited pro forma information is not necessarily indicative of the combined results that would have occurred had the acquisition taken place at the beginning of the periods presented, nor is it necessarily indicative of future results.

| (unaudited)<br>Year Ended December 31, | 1999 | 2000 |
|---|---|---|
| Revenue | $ 44,540 | $ 65,290 |
| Net loss | $ (4,070) | $ (2,023) |
| Net loss per share (basic and diluted) | $ (0.19) | $ (0.06) |

During 2000, the Company acquired two smaller companies, Embedded Technologies, Inc. and ToolCraft KK, for total cash and stock consideration of approximately $5.0 million. Both of these acquisitions were accounted for using the purchase method of accounting, and the purchase prices were allocated to the fair value of the acquired assets.

Additionally, the Company made several strategic investments during the year ended December 31, 2000 totaling $4.9 million, which are reflected in "Investments" in the accompanying balance sheets. These investments are included in other assets and are accounted for under the cost method as our ownership is less than 20% and we do not have significant influence. To the extent that the capital stock held is in a public company and the securities have a quoted market price, then the investment is marked to market. Our policy is to regularly review the operating performance in assessing the carrying value of the investment. Pursuant to the terms of these agreements, the Company has certain rights to acquire approximately 791,000 shares of these entities under certain conditions for additional consideration. We expect to continue to make additional investments in the future.



# Directors and Officers

**Directors**

**William T. Baxter**
Chairman of the Board

**Jeffrey T. Chambers**
Member, TA Associates

**Albert T. Dosser**
Senior Vice President, BSQUARE

**Scot E. Land**
Managing Director,
Encompass Ventures

**William Larson**
Former Chief Executive Officer
and Chairman of the Board,
Network Associates, Inc.

**Officers**

**William T. Baxter**
Chief Executive Officer

**Albert T. Dosser**
Senior Vice President

**Thomas A. Schild**
Senior Vice President,
Worldwide Sales and
International Operations

**Brian V. Turner**
President and
Chief Operating Officer

**Donald L. Whitt**
Vice President and
General Manager

**Corporate Vice Presidents**

**Scott E. Bufkin**
Vice President, Professional
Engineering Services

**Diane M. Istvan**
Vice President, Legal Affairs

**Leila L. Kirske**
Vice President,
Finance and Administration

**Lewis C. Larson**
Vice President, Marketing

**Christiane M. Liebe**
Vice President,
Information Technology

**J. Jeffrey McLeman**
Vice President, Products

**Joseph Notarangelo**
Vice President,
Business Development

**Denise Rubin**
Vice President,
Human Resources

## Corporate Information

**Global Office Locations**

**Headquarters**
3150 139th Avenue SE
Suite 500
Bellevue, Washington 98005
Tel: 425-519-5900
Fax: 425-519-5999
www.bsquare.com

**Munich, Germany**
BSQUARE GmbH
Lilientahlstrasse 25
D-85399 Halbergmoos, Germany
Tel: 011-49-811-600-590
Fax: 011-49-811-600-5959

**Tokyo, Japan**
BSQUARE KK
Kubo Building 2-9-2 Yoyogi
Shibuya-Ku, Tokyo
101-0053 Japan
Tel: 81-03-5304-1051
Fax: 81-03-5304-1052

**BSQUARE Silicon Valley Corporation**
255 San Geronimo Way
Sunnyvale, California 94086

**Embedded Technologies Inc.**
7500 Flying Cloud Drive
8th Floor
Eden Prairie, Minnesota 55344

**Transfer Agent and Registrar**

Mellon Investor Services, L.L.C.
85 Challenger Road
Ridgefield Park, NJ 07660
Tel: 800-522-6645
www.mellon-investor.com

**Legal Counsel**

Summit Law Group
Seattle, Washington

**Independent Public Accountants**

Arthur Andersen LLP
Seattle, Washington

**Annual Meeting**

The annual meeting of shareholders will be held on Monday, April 30, 2001, 10:00 A.M. at BSQUARE Corporate Headquarters, 3150 139th Avenue SE, Bellevue, WA.

**Form 10-k**

BSQUARE files an Annual Report with the Securities and Exchange Commission on Form 10-K. Copies are available from BSQUARE without charge upon request. Requests should be sent to: investorrelations@bsquare.com

**Stock Exchange Listing**

Our common stock is traded on the Nasdaq National Market under the symbol "BSQR."

**Stock Price and Shareholder Information**

The following table sets forth the high and low quarterly sales prices of our common stock as reported on the Nasdaq National Market since October 20, 1999, the date our common stock commenced trading.

| | High | Low |
|---|---|---|
| 12/31/00 | $ 18.13 | $ 5.38 |
| 09/30/00 | $ 25.25 | $ 14.38 |
| 06/30/00 | $ 26.00 | $ 12.00 |
| 03/31/00 | $ 53.50 | $ 20.81 |
| 12/31/99 | $ 56.50 | $ 21.66 |

As of January 30, 2001 the Company had 172 shareholders of record.

**Dividends**

We have never paid cash dividends on our common stock other than the distribution of S corporation earnings prior to October 1997, when we converted to a C corporation. We currently intend to retain any future earnings to fund the development and growth of our business. Therefore, we do not currently anticipate paying any cash dividends in the foreseeable future. In addition, the terms of our current credit facility prohibit us from paying dividends without our lender's consent.

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